Pension Review Board
Actuarial Committee

August 28, 2020

Funding Policy and Funding Soundness Restoration Plan Requirements
Policy Objectives and Considerations

INTRODUCTION

At the June 30, 2020 PRB meeting, staff provided a list of potential policy issues relating to the funding policy and funding soundness restoration plan statutory requirements. The Board discussed the issues and asked staff to work with the Actuarial Committee to develop recommendations to address the issues. On August 6, the Actuarial Committee had preliminary discussion on the objectives and potential statutory changes below and asked staff to solicit stakeholder input to bring to the next committee meeting on September 29.

OBJECTIVES

1. **<u>Funding policy and funding soundness restoration plan requirements should be in sync.</u>**

Funding policy and FSRP requirements are currently separate and do not tie together to form a continuum of funding support to plans and sponsors. The funding policy requirement, enacted in 2019, requires plans to adopt a funding policy targeting full funding. The FSRP statute, enacted in 2015, requires plans and their sponsors to adopt a remediation plan if the unfunded liability cannot be amortized over 40 or fewer years.

Now that plans have funding policies, they have long-term plans to achieve full funding. However, the remediation plan requirement for plans that face serious funding shortfalls operates independently of the newer funding policy mandate and does not require plans to target full funding over a reasonable closed period.

To provide an effective continuum of funding support for Texas pension plans, the FSRP, which is designed to quickly shore up dramatic funding problems, should tie back to the funding policy, which is designed to prevent funding deficiencies.

No specific potential change; addressed through other objectives below.

2. Plan sponsors should share in plan ownership and needed changes.

Plan sponsors are not required to be involved in the funding policy development process. The PRB has continually recommended that funding policies should be established in conjunction with the plan sponsor. Funding policies received from plans that did collaborate with their sponsors included risk-sharing components, such as splitting needed contribution increases and considering benefit changes, ensuring the sponsor shared in the ownership of the plan. Through intensive actuarial reviews, the PRB has also worked with sponsors and plan representatives to assist plans with addressing funding deficiencies, recommending in all 11 intensive reviews that the plan and sponsor collaborate on an appropriate funding policy to prevent further problems.

Potential Change to Funding Policy Requirement

2a) Add the sponsor to the funding policy requirement so that both the pension board and plan sponsor have ownership in the plan to achieve full funding rather than only in the remediation plan once funding problems require immediate action. Specifically, require the plan and sponsor to jointly develop the funding policy.

Potential Changes to FSRP Requirement (also addresses Objective 1)

2b) Since the sponsor is already part of the FSRP process in Texas, one way to link the two laws and enhance sponsor ownership could be to incorporate the funding policy into the FSRP. For example, if an FSRP were triggered, the plan and sponsor could be required to do two things: adopt a remediation plan (FSRP) and revise the funding policy, together, to ensure both parties are involved in long-term improvement. For FSRP plans, the revised funding policy could have to include certain elements such as a detailed plan to share the cost of unexpected actuarial losses that could derail progress toward the FSRP goal.

2c) Require the sponsor's governing body (e.g., city council) to adopt the FSRP through resolution to ensure full sponsor involvement and ownership.

3. Clarify that funding policies must include actuarial methods that achieve 100% funding.

The PRB Actuarial Committee at its May 7, 2020 meeting discussed how rolling amortization periods were not designed to achieve full funding. Most standard-setting bodies listed below under Objective 4 utilize closed amortization approaches.

Potential Change to Funding Policy Requirement

3a) Require funding policies to utilize actuarial methods (amortization policies for ADC plans or ADC benchmarks for fixed-rate plans) that are based on a closed amortization period, and thus, move toward, and ultimately achieve, 100% funding.

4. <u>Reduce the 40-year amortization period.</u>

A rolling 40-year amortization period threshold is no longer reasonable. Generally, an amortization period over 20 years will cause a plan to experience negative amortization, which means the unfunded liability will grow, rather than decrease, as contributions will not cover the interest accrued. The following sources recommend shorter amortization periods.

CCA White Paper - recommends a layered, fixed period amortization depending on the source of the UAAL, with a 25-yr max.

SOA Blue Ribbon Panel - recommends gains/losses to be amortized over a period of no more than 15-20 years.

GFOA - recommends using a closed period never to exceed 25 years, but to fall between 15-20 years.

PRB *Pension Funding Guidelines* - utilize a 30-year threshold, with a preferred period of 10-25 years.

ASOP 4 Second Exposure Draft - states that each amortization base must either have payments that fully pay off the balance within a reasonable timeframe; or reduce the unfunded balance by a reasonable amount each year.

Potential Change to FSRP Requirement

4a) Bring the FSRP trigger in line with *PRB Guidelines* and other standard-setting bodies by changing 40 years (11 plans currently subject to FSRP) to:

- 30 years (*PRB Guidelines* upper bound) – 19 additional plans would become subject to FSRP, for a total of 30 plans;
- 25 years (*PRB Guidelines* target range upper bound) – 34 additional plans would become subject to FSRP, for a total of 45 plans; or
- 20 years (within *PRB Guidelines* and GFOA target range, SOA Blue Ribbon Panel upper bound) – 51 additional plans would become subject to FSRP, for a total of 62 plans.

5. **<u>Reduce the period between identification of an amortization period beyond the threshold and trigger of an FSRP.</u>**

The time period between the first actuarial valuation over the threshold and when the FSRP is triggered can be lengthy. The FSRP requirement is triggered after three consecutive annual AVs, or two consecutive AVs if the systems conduct the valuations every two or three years, which could allow funding problems to grow considerably worse between valuations.

<u>*Additional Considerations*</u>

Setting the target lower than the threshold: The FSRP target does not have to be the same period as the threshold. Plans and their sponsors could be required to formulate an FSRP that targets a lower amortization period than the threshold. For example, the threshold to trigger an FSRP could be the upper bound of the *PRB Guidelines* (30 years), but the FSRP could be required to achieve an amortization period within the preferred target range of 10-25 years.

Plans that have made recent funding improvements: Plans that have recently made significant reforms including implementing an ADC or modified-ADC approach based on a closed amortization period in line with *PRB Guidelines* could still have amortization periods in the FSRP threshold range over a few valuations. As such, consideration should be given to plans with several valuations showing amortization period over the lowered FSRP threshold if their AVs indicate a path towards full funding (i.e. funding according to a closed amortization period that decreases each year).

<u>***Potential Changes to FSRP Requirement***</u>

<u>*Timing of Trigger*</u>

<u>*5a)*</u> The FSRP requirement is triggered immediately for plans that receive an AV with the amortization period over a higher threshold only; existing law applies to amortization periods over a lower threshold.

For example, if an AV showing an amortization period over 40 is received, the FSRP would be immediately required, given that at higher amortization periods, funding problems can quickly accelerate, as higher amortization periods are much more volatile (i.e., can jump from 40 to infinite over one valuation cycle) . For amortization periods above 25 but not above 40, existing law would continue to apply (the FSRP is triggered after three consecutive annual AVs, or two consecutive AVs if the systems conduct the valuations every two or three years).

OR

<u>*5b)*</u> The FSRP requirement is triggered immediately for plans that receive an AV with the amortization period over a higher threshold only; for plans reporting amortization periods over a lower threshold, an additional metric would apply to determine FSRP status.

For example, if an AV showing an amortization period over 40 is received, the FSRP would be immediately required. For amortization periods above 25 but not above 40, only plans that also had funded ratios of less than 65% would become subject to the FSRP, as the two factors considered together provide a clearer picture of the severity of funding problems.

Setting the Target Lower than the Threshold (also addresses Objective 1)

5c) If the threshold to trigger an FSRP was 30 years, the FSRP would be required to achieve an amortization period within 10-25 years.

Consideration for Plans Having Made Funding Reforms

5d) Plans with amortization periods between 30 and 40 years do not become subject to the FSRP requirement if they are implementing an ADC or modified-ADC contribution structure and their AVs indicate they are on a path towards full funding.

6. Clarify the role of future actions in FSRPs.

Some FSRPs rely on future actions that may or may not happen. Staff seeks clarification as to what extent future actions may be incorporated in FSRPs. For example, can an FSRP include a benefit change that has not yet been voted on by members; feature contribution increases not yet approved by the sponsor; or rely on future increases in active plan population for the existing amortization period calculations?

Potential Changes to FSRP Requirement

6a) When changes must be made that require significant time to implement or are contingent on a voting process or other approval, require the FSRP to include evidence of intent, such as the following:

a) a resolution or motion from the sponsor approving additional funding or contribution schedules for contribution increases phased in over time;

b) draft ballot language and an estimated date the vote will take place.

6b) Clarify that any assumptions used in conjunction with future actions, such as hiring, must be made in accordance with ASOPs.

6c) The plan and sponsor must provide updates to the Board within 6 months on the implementation of the future actions outlined in the FSRP.

7. **<u>Clarify documentation required to demonstrate that FSRP will achieve the amortization period requirement.</u>**

Supporting documentation requirements are unclear. Staff seeks clarification regarding what evidence must be provided to show that the FSRP meets the amortization period requirement. For example, does an analysis of individual pieces of the changes and assurance from the system and/or plan actuary that the combined impact will achieve the necessary amortization period suffice, or must the FSRP contain an analysis of the combined impact of all changes?

Potential Change to FSRP Requirement

7a) FSRPs must provide an aggregate analysis of multiple changes specifically showing how the combined impact of the changes in the FSRP would result in meeting the statutory requirements. The analysis must include an actuarial projection that shows the unfunded liability decreasing to zero within the required time period.

8. **<u>Identify consequences that should apply when an FSRP does not result in statutory compliance. Perpetual revised FSRPs should be discouraged.</u>**

Preparing a revised FSRP does not ensure a plan is back on track towards the original FSRP goal. Statute calls for a revised FSRP if the original is not adhered to. To date, several systems have been required to formulate revised FSRPs, and some are on their second revised FSRP. There are no consequences in place to prevent perpetual revised FSRPs, which means a plan may never achieve the minimum amortization period threshold and may have no incentive to make meaningful changes in the original FSRP.

Potential Change to FSRP Requirement

8a) If the original FSRP will no longer achieve the statutory amortization period requirement, the plan and sponsor should become subject to stricter requirements for funding restoration, such as adopting risk-sharing mechanisms in their funding policy or an ADC-based contribution structure.

9. Clarify effective dates and required documentation for FSRP triggers and progress.

Progress updates and criteria for determining adherence to the FSRP require clarification. Statute requires systems and sponsors that formulate an FSRP to report "any updates of progress made by the entities toward improved actuarial soundness" to the PRB every two years. A revised FSRP must be formulated if the "system's amortization period exceeds 40 years and the previously formulated FSRP has not been adhered to."

Staff seeks clarification as to what the 2-year progress updates should include and what indicates the prior FSRP has been "adhered to." What evidence should the system provide to illustrate that the required 40-year amortization period is still expected to be achieved by the original deadline? Does a plan's actuarial valuation provide enough evidence?

Potential Change to FSRP Requirement (also addresses Objective 2)

9a) To track progress on the FSRP, plans and sponsors should provide updates to the Board at least every two years, based on actual progress made.

9b) Updates should be provided on a PRB form and signed by the sponsor and/or adopted by city council. Updates should include an actuarial projection that shows the unfunded liability decreasing to zero within the required time period. Statute should clarify that the actuarial valuation alone does not qualify as an FSRP update.

10. Clarify deadline for submittal of FSRPs.

FSRP deadlines do not prevent substantial delays or speak to the time period over which a revised FSRP must achieve results. Although the bill author clarified the deadline to formulate an FSRP is 6 months from the adoption of the AV that triggers the formulation requirement, this deadline is not currently in statute. Plans and sponsors subject to the FSRP have missed the 6-month FSRP formulation deadline, sometimes by several years. Understandably, sometimes the plan and sponsor need more time to finalize their FSRP.

Statute does not address how to handle late FSRPs, which requires striking a balance between allowing time for the development of a thorough joint plan but also preventing extremely delayed FSRPs.

Potential Changes to FSRP Requirement

10a) Statute should be updated to include the 6 month deadline and to provide for an extension process that the PRB may grant if a reasonable draft is submitted with an extension request, so that the PRB, Legislature, and other stakeholders could be made aware of the plan and sponsor's intended plan of action. If the allowed number of extensions is met and the FSRP is still not submitted or accepted by the PRB, the plan and sponsor would be noncompliant with statute.

OR

10b) Statute should be amended to allow one year, rather than 6 months, for the completion of the FSRP, but also to require a progress update at 6 months which should include a draft plan or changes under consideration.